

May 8, 2002

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows.

PART 1--INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. Sections 1.457-1, 1.457-2, 1.457-3 and 1.457-4 are revised to read as follows:

Sec. 1.457-1 General overview of section 457.

Section 457 provides rules for nonqualified deferred compensation plans established by eligible employers as defined under Sec. 1.457-2(d). Eligible employers can establish either deferred compensation plans that are eligible plans and that meet the requirements of section 457(b) and Secs. 1.457-3 through 1.457-10, or deferred compensation plans or arrangements that do not meet the requirements of section 457(b) and Secs. 1.457-3 through 1.457-10 and that are subject to tax treatment under section 457(f) and Sec. 1.457-11.

Sec. 1.457-2 Definitions.

This section sets forth the definitions that are used under Secs. 1.457-1 through 1.457-11.

(a) Amount(s) deferred. Amount(s) deferred means the total annual deferrals under an eligible plan in the current and prior years, adjusted for gain or loss. Except as otherwise specifically indicated, amount(s) deferred includes any rollover amount held by an eligible plan as provided under Sec. 1.457-10(e).

(b) Annual deferral(s)--(1) Annual deferral(s) means, with respect to a taxable year, the amount of compensation deferred under an eligible plan, whether by salary reduction or by nonelective employer contribution. The amount of compensation deferred under an eligible plan is taken into account as an annual deferral in the taxable year of the participant in which deferred, or, if later, the year in which the amount of compensation deferred is no longer subject to a substantial risk of forfeiture.

(2) If the amount of compensation deferred under the plan during a taxable year is not subject to a substantial risk of forfeiture, the amount taken into account as an annual deferral is not adjusted to reflect gain or loss allocable to the compensation deferred. If, however, the amount of compensation deferred under the plan during the taxable year is subject to a substantial risk of forfeiture, the amount of compensation deferred that is taken into account as an annual deferral in the taxable year in which the substantial risk of forfeiture lapses must be adjusted to reflect gain or loss allocable to the compensation deferred until the substantial risk of forfeiture lapses.

(3) If the eligible plan is a defined benefit plan within the meaning of section 414(j), the annual deferral for a taxable year is the present value of the increase during the taxable year of the participant's accrued benefit that is not subject to a substantial risk of forfeiture (disregarding any such increase attributable to prior annual deferrals). For this purpose, present value must be determined using actuarial assumptions and methods that are reasonable (both individually and in the aggregate), as determined by the Commissioner.

(c) Beneficiary. Beneficiary means a beneficiary of a participant, a participant's estate, or any other person whose interest in the plan is derived from the participant, including an alternate payee as described in Sec. 1.457-10(c).

(d) Catch-up. Catch-up amount or catch-up limitation for a participant for a taxable year means the annual deferral permitted under section 414(v) (as described in Sec. 1.457-4(c)(2)) or section 457(b)(3) (as described in Sec. 1.457-4(c)(3)) to the extent the amount of the annual deferral for the participant for the taxable year is permitted to exceed the plan ceiling applicable under section 457(b)(2) (as described in Sec. 1.457-4(c)(1)).

(e) Eligible employer. Eligible employer means an entity that is a state as defined in paragraph (l) of this section that establishes a plan or a tax-exempt entity as defined in paragraph (m) of this section that establishes a plan. The performance of services as an independent contractor for a state or local government or a tax-exempt entity is treated as the performance of services for an eligible employer. The term eligible employer does not include a church as defined in section 3121(w)(3)(A), a qualified church-controlled organization as defined in section 3121(w)(3)(B), or the Federal government or any agency or instrumentality thereof.

(f) Eligible plan. An eligible plan is a plan that meets the requirements of Secs. 1.457-3 through 1.457-10 that is established and maintained by an eligible employer. An eligible governmental plan is an eligible plan that is established and maintained by an eligible employer as defined in paragraph (l) of this section. An arrangement

does not fail to constitute a single eligible governmental plan merely because the arrangement is funded through more than one trustee, custodian, or insurance carrier. An eligible plan of a tax-exempt entity is an eligible plan that is established and maintained by an eligible employer as defined in paragraph (m) of this section.

(g) Includible compensation. Includible compensation of a participant means, with respect to a taxable year, the participant's compensation, as defined in section 415(c)(3), for services performed for the eligible employer. The amount of includible compensation is determined without regard to any community property laws.

(h) Ineligible plan. Ineligible plan means a plan established and maintained by an eligible employer that is not maintained in accordance with Secs. 1.457-3 through 1.457-10. A plan that is not established by an eligible employer as defined in paragraph (e) of this section is neither an eligible nor an ineligible plan.

(i) Nonelective employer contribution. A nonelective employer contribution is a contribution made by an eligible employer for the participant with respect to which the participant does not have the choice to receive the contribution in cash or property. Solely for purposes of section 457 and Secs. 1.457-2 through 1.457-11, the term nonelective employer contribution includes employer contributions that would be described in section 401(m) if they were contributions to a qualified plan.

(j) Participant. Participant in an eligible plan means an individual who is currently deferring compensation, or who has previously deferred compensation under the plan by salary reduction or by nonelective employer contribution and who has not received a distribution of his or her entire benefit under the eligible plan. Only individuals who perform services for the eligible employer, either as an employee or as an independent contractor, may defer compensation under the eligible plan.

(k) Plan. Plan includes any agreement or arrangement between an eligible employer and a participant or participants under which the payment of compensation is deferred (whether by salary reduction or by nonelective employer contribution). The following types of plan are not treated as agreements or arrangement under which compensation is deferred: a bona fide vacation leave, sick leave, compensatory time, severance pay, disability pay, or death benefit plan described in section 457(e)(11)(A)(i) and any plan paying length of service awards to bona fide volunteers (and their beneficiaries) on account of qualified services performed by such volunteers as described in section 457(e)(11)(A)(ii). Further, the term plan does not include any of the following (and section 457 and Secs. 1.457-2 through 1.457-11 do not apply to any of the following)--

(1) Any nonelective deferred compensation under which all individuals (other than those who have not satisfied any applicable initial service requirement) with the same relationship with the

eligible employer are covered under the same plan with no individual variations or options under the plan as described in section 457(e)(12), but only to the extent the compensation is attributable to services performed as an independent contractor;

(2) An agreement or arrangement described in Sec. 1.457-11(b);

(3) Any plan satisfying the conditions in section 1107(c)(4) of the Tax Reform Act of 1986 (TRA '86) (relating to certain plans for state judges); and

(4) Any of the following plans or arrangements (to which specific transitional statutory exclusions apply)--

(i) A plan or arrangement of a tax-exempt entity in existence prior to January 1, 1987, if the conditions of section 1107(c)(3)(B) of the TRA '86, as amended by section 1011(e)(6) of Technical and Miscellaneous Revenue Act of 1988 (TAMRA), are satisfied;

(ii) A collectively bargained nonelective deferred compensation plan in effect on December 31, 1987, if the conditions of section 6064(d)(2) of TAMRA are satisfied;

(iii) Amounts described in section 6064(d)(3) of TAMRA (relating to certain nonelective deferred compensation arrangements in effect before 1989); and

(iv) Any plan satisfying the conditions in section 1107(c)(4) or (5) of TRA '86 (relating to certain plans for certain individuals with respect to which the Service issued guidance before 1977).

(l) State. State includes the 50 States of the United States, the District of Columbia, a political subdivision of a state or the District of Columbia, or any agency or instrumentality of a state or the District of Columbia.

(m) Tax-exempt entity. Tax-exempt entity includes any organization (other than a governmental unit) exempt from tax under subtitle A of the Internal Revenue Code.

(n) Trust. Trust means a trust described under section 457(g) and Sec. 1.457-8. Custodial accounts and contracts described in section 401(f) are treated as trusts under the rules described in Sec. 1.457-8(a)(2).

Sec. 1.457-3 General introduction to eligible plans.

(a) Compliance in form and operation. An eligible plan is a written plan established and maintained by an eligible employer that is maintained, in both form and operation, in accordance with the requirements of Secs. 1.457-4 through 1.457-10. An eligible plan must contain all the material terms and conditions for benefits under the plan. An eligible plan may contain certain optional features not required for plan eligibility under section 457(b), such as distributions for unforeseeable emergencies, loans, plan-to-plan

transfers, additional deferral elections, acceptance of rollovers to the plan, and distributions of smaller accounts to eligible participants. However, except as otherwise specifically provided in Secs. 1.457-4 through 1.457-10, if an eligible plan contains any optional provisions, the optional provisions must meet, in both form and operation, the relevant requirements under section 457 and Secs. 1.457-2 through 1.457-10.

(b) Treatment as single plan. In any case in which multiple plans are used to avoid or evade the requirements of Secs. 1.457-4 through 1.457-10, the Commissioner may apply the rules under Secs. 1.457-4 through 1.457-10 as if the plans were a single plan.

Sec. 1.457-4 Annual deferrals, deferral limitations, and deferral agreements under eligible plans.

(a) Taxation of annual deferrals. Annual deferrals that satisfy the requirements of paragraphs (b) and (c) of this section are excluded from the gross income of a participant in the year deferred or contributed and are not includible in gross income until paid to the participant in the case of an eligible governmental plan, or until paid or otherwise made available to the participant in the case of an eligible plan of a tax-exempt entity. See Sec. 1.457-7.

(b) Agreement for deferral. In order to be an eligible plan, the plan must provide that compensation may be deferred for any calendar month by salary reduction only if an agreement providing for the deferral has been entered into before the first day of the month in which the compensation is paid or made available. A new employee may defer compensation payable in the calendar month during which the participant first becomes an employee if an agreement providing for the deferral is entered into on or before the first day on which the participant performs services for the eligible employer. An eligible plan may provide that if a participant enters into an agreement providing for deferral by salary reduction under the plan, the agreement will remain in effect until the participant revokes or alters the terms of the agreement. Nonelective employer contributions are treated as being made under an agreement entered into before the first day of the calendar month.

(c) Maximum deferral limitations--(1) Basic annual limitation. (i) Except as described in paragraphs (c)(2) and (3) of this section, in order to be an eligible plan, the plan must provide that the annual deferral amount for a taxable year (the plan ceiling) may not exceed the lesser of--

(A) The applicable annual dollar amount specified in section 457(e)(15): \$11,000 for 2002; \$12,000 for 2003; \$13,000 for 2004; \$14,000 for 2005; and \$15,000 for 2006 and thereafter. After 2006, the

\$15,000 amount is adjusted for cost-of-living in the manner described in paragraph (c)(4) of this section; or

(B) 100 percent of the participant's includible compensation for the taxable year.

(ii) The amount of annual deferrals permitted by the 100 percent of includible compensation limitation under paragraph (c)(1)(i)(B) of this section is determined under section 457(e)(5) and Sec. 1.457-2(g).

(iii) For purposes of determining the plan ceiling under this paragraph (c), the annual deferral amount does not include any rollover amounts received by the eligible plan under Sec. 1.457-10(e).

(iv) The provisions of this paragraph (c)(1) are illustrated by the following examples:

Example 1. (i) Facts. Participant A, who earns \$14,000 a year, enters into a salary reduction agreement in 2006 with A's eligible employer and elects to defer \$13,000 of A's compensation for that year. Participant A is not eligible for the catch-up described in paragraph (c)(2) or (3) of this section, participates in no other retirement plan, and has no other income exclusions taken into account in computing includible compensation.

(ii) Conclusion. The annual deferral limit for A in 2006 is the lesser of \$15,000 or 100 percent of includible compensation, \$14,000. A's annual deferral of \$13,000 is permitted under the plan because it is not in excess of \$14,000 and thus does not exceed 100 percent of A's includible compensation.

Example 2. (i) Facts. Assume the same facts as in Example 1, except that A's eligible employer provides an immediately vested, matching employer contribution under the plan for participants who make salary reduction deferrals under A's eligible plan. The matching contribution is equal to 100 percent of elective contributions, but not in excess of 10 percent of compensation (in A's case, \$1,400).

(ii) Conclusion. Participant A's annual deferral exceeds the limitations of this paragraph (c)(1). A's maximum deferral limitation in 2006 is \$14,000. A's salary reduction deferral of \$13,000 combined with A's eligible employer's nonelective employer contribution of \$1,400 exceeds the basic annual limitation of this paragraph (c)(1) because A's annual deferrals total \$14,400. A has an excess deferral for the taxable year of \$400, the amount exceeding A's permitted annual deferral limitation. The \$400 excess deferral is treated as described in paragraph (e) of this section.

Example 3. (i) Facts. Beginning in year 2002, Eligible Employer X contributes \$3,000 per year for five years to Participant B's eligible plan account. B's interest in the account vests in 2006. B has annual compensation of \$50,000 in each of the five years 2002 through 2006. Participant B is 41 years old. B is not eligible for

the catch-up described in paragraph (c)(2) or (3) of this section, participates in no other retirement plan, and has no other income exclusions taken into account in computing includible compensation. Adjusted for gain or loss, the value of B's benefit when B's interest in the account vests in 2006 is \$17,000.

(ii) Conclusion. Under this vesting schedule, \$17,000 is taken into account as an annual deferral in 2006. B's annual deferrals under the plan are limited to a maximum of \$15,000 in 2006. Thus, the aggregate of the amounts deferred, \$17,000, is in excess of the B's maximum deferral limitation by \$2,000. The \$2,000 is treated as an excess deferral described in paragraph (e) of this section.

(2) Age 50 catch-up--(i) In general. In accordance with section 414(v) and the regulations thereunder, an eligible governmental plan may provide for catch-up contributions for a participant who is age 50 by the end of the year, provided that such age 50 catch-up contributions do not exceed the catch-up limit under section 414(v)(2) for the taxable year. The maximum amount of age 50 catch-up contributions for a taxable year under section 414(v) is as follows: \$1,000 for 2002; \$2,000 for 2003; \$3,000 for 2004; \$4,000 for 2005; and \$5,000 for 2006 and thereafter. After 2006, the \$5,000 amount is adjusted for cost-of-living. For additional guidance, see regulations under section 414(v).

(ii) Coordination with special section 457 catch-up. In accordance with sections 414(v)(6)(C) and 457(e)(18), the age 50 catch-up described in this paragraph (c)(2) does not apply for any taxable year for which a higher limitation applies under the special section 457 catch-up under paragraph (c)(3) of this section. Thus, for purposes of this paragraph (c)(2)(ii) and paragraph (c)(3) of this section, the special section 457 catch-up under paragraph (c)(3) of this section applies for any taxable year if and only if the plan ceiling taking into account paragraphs (c)(1) and (3) of this section (and disregarding the age 50 catch-up described in this paragraph (c)(2)) is larger than the plan ceiling taking into account paragraph (c)(1) of this section and the age 50 catch-up described in this paragraph (c)(2) (and disregarding paragraph (c)(3) of this section). Thus, a participant who is eligible for the age 50 catch-up for a year and for whom the year is also one of the participant's last three taxable years ending before the participant attains normal retirement age is entitled to the larger of--

(A) The plan ceiling under paragraph (c)(1) of this section and the age 50 catch-up described in this paragraph (c)(2) (and disregarding paragraph (c)(3) of this section) or

(B) The plan ceiling under paragraphs (c)(1) and (3) of this section (and disregarding the age 50 catch-up described in this paragraph (c)(2)).

(iii) Examples. The provisions of this paragraph (c)(2) are illustrated by the following examples:

Example 1. (i) Facts. Participant C, who is 55, is eligible to participate in an eligible governmental plan in 2006. The plan provides a normal retirement age of 65. The plan provides limitations on annual deferrals up to the maximum permitted under paragraphs (c)(1) and (3) of this section and the age 50 catch-up described in this paragraph (c)(2). For 2006, C will receive compensation of \$40,000 from the eligible employer. C desires to defer the maximum amount possible in 2006. The applicable basic dollar limit of paragraph (c)(1)(i)(A) of this section is \$15,000 for 2006 and the additional dollar amount permitted under the age 50 catch-up is \$5,000 for 2006.

(ii) Conclusion. C is eligible for the age 50 catch-up in 2006 because C is 55 in 2006. However, C is not eligible for the special section 457 catch-up under paragraph (c)(3) of this section in 2006 because 2006 is not one of the last three taxable years ending before C attains normal retirement age. Accordingly, the maximum that C may defer for 2006 is \$20,000.

Example 2. (i) Facts. The facts are the same as in Example 1, except that, in 2006, C will attain age 62. The maximum amount that C can elect under the special section 457 catch-up under paragraph (c)(3) of this section is \$2,000 for 2006.

(ii) Conclusion. The maximum that C may defer for 2006 is \$20,000. This is the sum of the basic plan ceiling under paragraph (c)(1) of this section equal to \$15,000 and the age 50 catch-up equal to \$5,000. The special section 457 catch-up under paragraph (c)(3) of this section is not applicable since it provides a smaller plan ceiling.

Example 3. (i) Facts. The facts are the same as in Example 2, except that the maximum additional amount that C can elect under the special section 457 catch-up under paragraph (c)(3) of this section is \$7,000 for 2006.

(ii) Conclusion. The maximum that C may defer for 2006 is \$22,000. This is the sum of the basic plan ceiling under paragraph (c)(1) of this section equal to \$15,000, plus the additional special section 457 catch-up under paragraph (c)(3) of this section equal to \$7,000. The additional dollar amount permitted under the age 50 catch-up is not applicable to C for 2006 because it provides a smaller plan ceiling.

(3) Special section 457 catch-up--(i) In general. Except as provided in paragraph (c)(2)(ii) of this section, an eligible plan may provide that, for one or more of the participant's last three taxable

years ending before the participant attains "normal retirement age," the plan ceiling is an amount not in excess of the lesser of--

(A) Twice the dollar amount in effect under paragraph (c)(1)(i)(A) of this section; or

(B) The underutilized limitation determined under paragraph (c)(3)(ii) of this section.

(ii) Underutilized limitation. The underutilized amount determined under this paragraph (c)(3)(ii) is the sum of--

(A) The plan ceiling established under paragraph (c)(1) of this section for the taxable year; plus

(B) The plan ceiling established under paragraph (c)(1) of this section (or under section 457(b)(2) for any year before the applicability date of this section) for any prior taxable year or years, less the amount of annual deferrals under the plan for such prior taxable year or years (disregarding any annual deferrals under the plan permitted under the age 50 catch-up under paragraph (c)(2) of this section).

(iii) Determining underutilized limitation under paragraph (c)(3)(ii)(B) of this section. In determining the includible compensation of a participant under Sec. 1.457-2(g) for purposes of calculating the amount described in paragraph (c)(3)(ii)(A) of this section, includible compensation is not reduced by contributions of amounts described in paragraph (c)(3)(ii)(B) of this section. In addition, a prior taxable year is taken into account under paragraph (c)(3)(ii)(B) of this section only if it is a year beginning after December 31, 1978, in which the participant was eligible to participate in the plan, and in which compensation deferred (if any) under the plan during the year was subject to a plan ceiling established under paragraph (c)(1) of this section.

(iv) Special rules concerning application of the coordination limit for years prior to 2002 for purposes of determining the underutilized limitation--(A) General rule. For purposes of determining the underutilized limitation for years prior to 2002, participants remain subject to the rules in effect prior to the repeal of the coordination limitation under section 457(c)(2). Thus, the applicable basic annual limitation under paragraph (c)(1) of this section and the special section 457 catch-up under this paragraph (c)(3) for years in effect prior to 2002 are reduced, for purposes of determining a participant's underutilized amount under a plan, by amounts excluded from the participant's income for any prior taxable year by reason of a salary reduction or elective contribution under any other eligible section 457(b) plan, section 401(k) qualified cash or deferred arrangement, section 402(h)(1)(B) simplified employee pension (SARSEP), section 403(b) annuity contract, and section 408(p) simple retirement account, or under any plan for which a deduction is allowed because of a contribution to an organization described in section 501(c)(18) (pre-2002 coordination plans). Similarly, in applying the section

457(b)(2)(B) limitation for includible compensation for years prior to 2002, the limitation is 33 $\frac{1}{3}$ percent of the participant's compensation includible in gross income.

(B) Coordination limitation applied to participant. For purposes of determining the underutilized limitation for years prior to 2002, the coordination limitation applies to pre-2002 coordination plans of all employers for whom a participant has performed services, not only to those of the eligible employer. Thus, for purposes of determining the amount excluded from a participant's gross income in any prior taxable year under paragraph (c)(3)(ii)(B) of this section, the participant's annual deferral under an eligible plan, and salary reduction or elective deferrals under all other pre-2002 coordination plans, must be determined on an aggregate basis. To the extent that the combined deferral for years prior to 2002 exceeded the maximum deferral limitations, the amount is treated as an excess deferral under paragraph (e) of this section for those prior years.

(C) Special rule where no annual deferrals under the eligible plan. A participant who, although eligible, did not defer any compensation under the eligible plan in any given year before 2002 is not subject to the coordinated deferral limit, even though the participant may have deferred compensation under one of the other pre-2002 coordination plans. An individual is treated as not having deferred compensation under an eligible plan for a prior taxable year if all annual deferrals under the plan are distributed in accordance with paragraph (e) of this section. Thus, to the extent that a participant participated solely in one or more of the other pre-2002 coordination plans during a prior taxable year (and not the eligible plan), the participant is not subject to the coordinated limitation for that prior taxable year. However, the participant is treated as having deferred amounts in a prior taxable year for purposes of determining the underutilized limitation for that prior taxable year under this paragraph (c)(3)(iv)(C), but only to the extent that the participant's salary reduction contributions or elective deferrals under all pre-2002 coordination plans have not exceeded the maximum deferral limitations in effect under section 457(b) for that prior taxable year. To the extent an employer did not offer an eligible plan to an individual in a prior given year, no underutilized limitation is available to the individual for that prior year, even if the employee subsequently becomes eligible to participate in an eligible plan of the employer.

(D) Examples. The provisions of this paragraph (c)(3)(iv) are illustrated by the following examples:

Example 1. (i) Facts. In 2001 and in years prior to 2001, Participant D earned \$50,000 a year and was eligible to participate in both an eligible plan and a section 401(k) plan. However, D had always participated only in the section 401(k) plan and had always

deferred the maximum amount possible. For each year before 2002, the maximum amount permitted under section 401(k) exceeded the limitation of paragraph (c)(3)(i) of this section. In 2002, D is in the 3-year period prior to D's attainment of the eligible plan's normal retirement age of 65, and D now wants to participate in the eligible plan and make annual deferrals of up to \$30,000 under the plan's special section 457 catch-up provisions.

(ii) Conclusion. Participant D is treated as having no underutilized amount under paragraph (c)(3)(ii)(B) of this section for 2002 for purposes of the catch-up limitation under section 457(b)(3) and paragraph (c)(3) of this section because, in each of the years before 2002, D has deferred an amount in excess of the limitation of paragraph (c)(3)(i) of this section.

Example 2. (i) Facts. Assume the same facts as in Example 1, except that D only deferred \$2,500 per year under the section 401(k) plan for one year before 2002.

(ii) Conclusion. D is treated as having an underutilized amount under paragraph (c)(3)(ii)(B) of this section for 2002 for purposes of the special section 457 catch-up limitation. This is because D has deferred an amount for prior years that is less than the limitation of paragraph (c)(1)(i) of this section.

Example 3. (i) Facts. Participant E, who earned \$15,000 for 2000, entered into a salary reduction agreement in 2000 with E's eligible employer and elected to defer \$3,000 for that year. For 2000, E's eligible employer provided an immediately vested, matching employer contribution under the plan for participants who make salary reduction deferrals under E's eligible plan. The matching contribution was equal to 100 percent of elective contributions, but not in excess of 10 percent of compensation before salary reduction deferrals (in E's case, \$1,500). For 2000, E was not eligible for any catch-up contribution, participated in no other retirement plan, and had no other income exclusions taken into account in computing taxable compensation.

(ii) Conclusion. Participant E's annual deferral exceeded the limitations of section 457(b) for 2000. E's maximum deferral limitation in 2000 was \$4,000 because E's includible compensation was \$12,000 (\$15,000 minus the deferral of \$3,000) and the applicable limitation for 2000 was one-third of the individual's includible compensation (one-third of \$12,000 equals \$4,000). E's salary reduction deferral of \$3,000 combined with E's eligible employer's matching contribution of \$1,500 exceeded the limitation of section 457(b) for 2000 because E's annual deferrals totaled \$4,500. E had an excess deferral for 2000 of \$500, the amount exceeding E's permitted annual deferral limitation, and E's underutilized amount for 2000 is zero.

(v) Normal retirement age--(A) General rule. For purposes of the special section 457 catch-up in this paragraph (c)(3), a plan must specify the normal retirement age under the plan. A plan may define normal retirement age as any age that is on or after the earlier of age 65 or the age at which participants have the right to retire and receive, under the basic defined benefit pension plan of the state or tax-exempt entity, immediate retirement benefits without actuarial or similar reduction because of retirement before some later specified age, and that is not later than age 70½. Alternatively, a plan may provide that a participant is allowed to designate a normal retirement age within these ages. For purposes of the special section 457 catch-up in this paragraph (c)(3), an entity sponsoring more than one eligible plan may not permit a participant to have more than one normal retirement age under the eligible plans it sponsors.

(B) Special rule for eligible plans of qualified police or firefighters. An eligible plan with participants that include qualified police or firefighters as defined under section 415(b)(2)(H)(ii)(I) may designate a normal retirement age for such qualified police or firefighters that is earlier than the earliest normal retirement age designated under the general rule of paragraph (c)(3)(i)(A) of this section, but in no event may the normal retirement age be earlier than age 40. Alternatively, a plan may allow a qualified police or firefighter participant to designate a normal retirement age that is between age 40 and age 70½.

(vi) Examples. The provisions of this paragraph (c)(3) are illustrated by the following examples:

Example 1. (i) Facts. Participant F, who will turn 61 on April 1, 2006, becomes eligible to participate in an eligible plan on January 1, 2006. The plan provides a normal retirement age of 65. The plan provides limitations on annual deferrals up to the maximum permitted under paragraphs (c)(1) through (3) of this section. For 2006, F will receive compensation of \$40,000 from the eligible employer. F desires to defer the maximum amount possible in 2006. The applicable basic dollar limit of paragraph (c)(1)(i)(A) of this section is \$15,000 for 2006 and the additional dollar amount permitted under the age 50 catch-up in paragraph (c)(2) of this section for an individual who is at least age 50 is \$5,000 for 2006.

(ii) Conclusion. F is not eligible for the special section 457 catch-up under paragraph (c)(3) of this section in 2006 because 2006 is not one of the last three taxable years ending before F attains normal retirement age. Accordingly, the maximum that F may defer for 2006 is \$20,000. See also paragraph (c)(2)(iii) Example 1 of this section.

Example 2. (i) Facts. The facts are the same as in Example 1 except that, in 2006, F elects to defer only \$2,000 under the plan

(rather than the maximum permitted amount of \$20,000). In addition, assume that the applicable basic dollar limit of paragraph (c)(1)(i)(A) of this section continues to be \$15,000 for 2007 and the additional dollar amount permitted under the age 50 catch-up in paragraph (c)(2) of this section for an individual who is at least age 50 continues to be \$5,000 for 2007. In F's taxable year 2007, which is one of the last three taxable years ending before F attains the plan's normal retirement age of 65, F again receives a salary of \$40,000 and elects to defer the maximum amount permissible under the plan's catch-up provisions prescribed under paragraph (c) of this section.

(ii) Conclusion. For 2007, which is one of the last three taxable years ending before F attains the plan's normal retirement age of 65, the applicable limit on deferrals for F is the larger of the amount under the special section 457 catch-up or \$20,000, which is the basic annual limitation (\$15,000) and the age 50 catch-up limit of section 414(v) (\$5,000). For 2007, F's special section 457 catch-up amount is the lesser of two times the basic annual limitation (\$30,000) or the sum of the basic annual limitation (\$15,000) plus the \$13,000 underutilized limitation under paragraph (c)(3)(ii) of this section (the \$15,000 plan ceiling in 2006, minus the \$2,000 contributed for F in 2006), or \$28,000. Thus, the maximum amount that F may defer in 2007 is \$28,000.

Example 3. (i) Facts. The facts are the same as in Examples 1 and 2, except that F does not make any contributions to the plan before 2010. In addition, assume that the applicable basic dollar limitation of paragraph (c)(1)(i)(A) of this section continues to be \$15,000 for 2010 and the additional dollar amount permitted under the age 50 catch-up in paragraph (c)(2) of this section for an individual who is at least age 50 continues to be \$5,000 for 2010. In F's taxable year 2010, the year in which F attains age 65 (which is the normal retirement age under the plan), F desires to defer the maximum amount possible under the plan. F's compensation for 2010 is again \$40,000.

(ii) Conclusion. For 2010, the maximum amount that F may defer is \$20,000. The special section 457 catch-up provisions under paragraph (c)(3) of this section are not applicable because 2010 is not a taxable year ending before the year in which F attains normal retirement age.

(4) Cost-of-living adjustment. For years beginning after December 31, 2006, the \$15,000 dollar limitation in paragraph (c)(1)(i)(A) of this section will be adjusted to take into account increases in the cost-of-living. The adjustment in the dollar limitation is made at the same time and in the same manner as under section 415(d) (relating to qualified plans under section 401(a)), except that the base period is the calendar quarter beginning July 1, 2005 and any increase which is

not a multiple of \$500 will be rounded to the next lowest multiple of \$500.

(d) Deferral of sick, vacation, and back pay under an eligible plan--(1) In general. An eligible plan may provide that a participant may elect to defer accumulated sick pay, accumulated vacation pay, and back pay under an eligible plan if certain conditions are satisfied. The plan must provide, in accordance with paragraph (b) of this section, that these amounts may be deferred for any calendar month only if an agreement providing for the deferral is entered into before the beginning of the month in which the amounts would otherwise be paid or made available and the participant is an employee in that month. Any deferrals made under this paragraph (d)(1) under an eligible plan are subject to the maximum deferral limitations of paragraph (c) of this section.

(2) Examples. The provisions of this paragraph (d) are illustrated by the following examples:

Example 1. (i) Facts. Participant G, age 62, is a participant in an eligible plan providing a normal retirement age of 65. Under the terms of G's employer's eligible plan and G's sick leave plan, G may, during November of 2003 (which is one of the three years prior to normal retirement age), make a one-time election to contribute amounts representing accumulated sick pay to the eligible plan in December of 2003 (within the maximum deferral limitations). Alternatively, such amounts may remain in the "bank" under the sick leave plan. No cash out of the sick pay is available at any time prior to termination of employment. The total value of G's accumulated sick pay (determined, in accordance with the terms of the sick leave plan, by reference to G's current salary) is \$4,000 in December of 2003.

(ii) Conclusion. Under the terms of the eligible plan and sick leave plan, G may elect before December of 2003 to defer the \$4,000 value of accumulated sick pay under the eligible plan, provided that G's other annual deferrals to the eligible plan for 2003, when added to the \$4,000, do not exceed G's maximum deferral limitation for the year.

Example 2. (i) Facts. Employer X maintains an eligible plan and a vacation leave plan. Under the terms of the vacation leave plan, employees generally accrue three weeks of vacation per year. Up to one week's unused vacation may be carried over from one year to the next, so that in any single year an employee may have a maximum of four weeks vacation time. At the beginning of each calendar year, under the terms of the eligible plan (which constitutes an agreement providing for the deferral), the value of any unused vacation time from the prior year in excess of one week is automatically contributed to the eligible plan, to the extent of the employee's

maximum deferral limitations. Amounts in excess of the maximum deferral limitations are forfeited.

(ii) Conclusion. The value of the unused vacation pay contributed to X's eligible plan pursuant to the terms of the plan and the terms of the vacation leave plan is treated as an annual deferral to the eligible plan in the calendar year the contribution is made. No amounts contributed to the eligible plan will be considered made available to a participant in X's eligible plan.

(e) Excess deferrals under an eligible plan--(1) In general. Any amount deferred under an eligible plan for the taxable year of a participant that exceeds the maximum deferral limitations set forth in paragraphs (c)(1) through (3) of this section, and any amount that exceeds the individual limitation under Sec. 1.457-5, constitutes an excess deferral taxable in accordance with Sec. 1.457-11 for that taxable year. Thus, an excess deferral is includible in gross income in the taxable year deferred or, if later, the first taxable year in which there is no substantial risk of forfeiture.

(2) Excess deferrals under an eligible governmental plan other than as a result of the individual limitation. In order to be an eligible governmental plan, the plan must provide that any excess deferrals resulting from a failure of a plan to apply the limitations of paragraphs (c)(1) through (3) of this section to amounts deferred under the eligible plan (computed without regard to the individual limitation under Sec. 1.457-5) will be distributed to the participant, with allocable net income, as soon as administratively practicable after the plan determines that the amount is an excess deferral. For purposes of determining whether there is an excess deferral resulting from a failure of a plan to apply the limitations of paragraphs (c)(1) through (3) of this section, all plans under which an individual participates by virtue of his or her relationship with a single employer are treated as a single plan. An eligible governmental plan does not fail to satisfy the requirements of paragraphs (a) through (d) of this section or Secs. 1.457-6 through 1.457-10 (including the distribution rules under Sec. 1.457-6 and the funding rules under Sec. 1.457-8) solely by reason of a distribution made under this paragraph (e)(2). If such excess deferrals are not corrected by distribution under this paragraph (e)(2), the plan will be an ineligible plan under which benefits are taxable in accordance with Sec. 1.457-11.

(3) Excess deferrals under an eligible plan of a tax-exempt employer other than as a result of the individual limitation. If a plan of a tax-exempt employer fails to comply with the limitations of paragraphs (c)(1) through (3) of this section, the plan will be an ineligible plan under which benefits are taxable in accordance with Sec. 1.457-11. For purposes of determining whether there is an excess deferral resulting from a failure of a plan to apply the limitations of

paragraphs (c)(1) through (3) of this section, all plans under which an individual participates by virtue of his or her relationship with a single employer are treated as a single plan.

(4) Excess deferrals arising from application of the individual limitation. An eligible plan may provide that an excess deferral as a result of a failure to comply with the individual limitation under Sec. 1.457-5 for a taxable year may be distributed to the participant, with allocable net income, as soon as administratively practicable after the plan determines that the amount is an excess deferral. An eligible plan does not fail to satisfy the requirements of paragraphs (a) through (d) of this section or Secs. 1.457-6 through 1.457-10 (including the distribution rules under Sec. 1.457-6 and the funding rules under Sec. 1.457-8) solely by reason of a distribution made under this paragraph (e)(4). Although a plan will still maintain eligible status if excess deferrals are not distributed under this paragraph (e)(4), a participant must include the excess amounts in income as provided in paragraph (e)(1) of this section.

(5) Examples. The provisions of this paragraph (e) are illustrated by the following examples:

Example 1. (i) Facts. In 2006, the eligible plan of State Employer X in which Participant H participates permits a maximum deferral of the lesser of \$15,000 or 100 percent of includible compensation. In 2006, H, who has compensation of \$28,000, nevertheless defers \$16,000 under the eligible plan. Participant H is age 45 and normal retirement age under the plan is age 65. For 2006, the applicable dollar limit under paragraph (c)(1)(i)(A) of this section is \$15,000.

(ii) Conclusion. Participant H has deferred \$1,000 in excess of the \$15,000 limitation provided for under the plan for 2006. The \$1,000 excess must be included by H into H's income for 2006. In order to correct the failure and still be an eligible plan, the plan must distribute the excess deferral, with allocable net income, as soon as administratively practicable after determining that the amount exceeds the plan deferral limitations. If the excess deferral is not distributed, the plan will be an ineligible plan with respect to which benefits are taxable in accordance with Sec. 1.457-11.

Example 2. (i) Facts. The facts are the same as in Example 1, except that H's deferral under the eligible plan is limited to \$11,000 and H also makes a salary reduction contribution of \$5,000 to an annuity contract under section 403(b) with the same Employer X.

(ii) Conclusion. H's deferrals are within the plan deferral limitations of Employer X. Because of the repeal of the application of the coordination limitation under former paragraph (2) of section 457(c), H's salary reduction deferrals under the annuity contract

are no longer considered in determining H's applicable deferral limits under paragraphs (c)(1) through (3) of this section.

Example 3. (i) Facts. The facts are the same as in Example 1, except that H's deferral under the eligible governmental plan is limited to \$14,000 and H also makes a deferral of \$4,000 to an eligible governmental plan of a different employer. Participant H is age 45 and normal retirement age under both eligible plans is age 65.

(ii) Conclusion. Because of the application of the individual limitation under Sec. 1.457-5, H has an excess deferral of \$3,000 (the sum of \$14,000 plus \$4,000 equals \$18,000, which is \$3,000 in excess of the dollar limitation of \$15,000). The \$3,000 excess deferral, with allocable net income, may be distributed from either plan as soon as administratively practicable after determining that the combined amount exceeds the deferral limitations. If the \$3,000 excess deferral is not distributed to H, each plan will continue to be an eligible plan, but the \$3,000 must be included by H into H's income for 2006.

Example 4. (i) Facts. Assume the same facts as in Example 3, except that H's deferral under the eligible governmental plan is limited to \$14,000 and H also makes a deferral of \$4,000 to an eligible plan of Employer Y, a tax-exempt entity.

(ii) Conclusion. The results are the same as in Example 3, i.e., because of the application of the individual limitation under Sec. 1.457-5, H has an excess deferral of \$3,000. If the \$3,000 excess deferral is not distributed to H, each plan will continue to be an eligible plan, but the \$3,000 must be included by H into H's income for 2006.

Par. 3. Sections 1.457-5 through 1.457-12 are added to read as follows:

Sec. 1.457-5 Individual limitation for combined annual deferrals under multiple eligible plans

(a) General rule. The individual limitation under section 457(c) and this section equals the basic annual deferral limitation under Sec. 1.457-4(c)(1)(i)(A), the age 50 catch-up amount under Sec. 1.457-4(c)(2), and the special section 457 catch-up amount under Sec. 1.457-4(c)(3), applied by taking into account the combined annual deferral for the participant for any taxable year under all eligible plans. While an eligible plan may include provisions under which it will meet the individual limitation under section 457(c) and this section, annual deferrals by a participant that exceed the individual limit under section 457(c) and this section will not cause a plan to lose its

eligible status. However, to the extent the combined annual deferrals for a participant for any taxable year exceed the individual limitation under section 457(c) and this section for that year, the amounts are treated as excess deferrals as described in Sec. 1.457-4(e).

(b) Limitation applied to participant. The individual limitation in this section applies to eligible plans of all employers for whom a participant has performed services, including both eligible governmental plans and eligible plans of a tax-exempt entity and both eligible plans of the employer and eligible plans of other employers. Thus, for purposes of determining the amount excluded from a participant's gross income in any taxable year (including the underutilized limitation under Sec. 1.457-4(c)(3)(ii)(B)), the participant's annual deferral under an eligible plan, and the participant's annual deferrals under all other eligible plans, must be determined on an aggregate basis. To the extent that the combined annual deferral amount exceeds the maximum deferral limitation applicable under Sec. 1.457-4(c)(1)(i)(A), (c)(2), or (c)(3), the amount is treated as an excess deferral under Sec. 1.457-4(e).

(c) Special rules for catch-up amounts under multiple eligible plans. For purposes of applying section 457(c) and this section, the special section 457 catch-up under Sec. 1.457-4(c)(3) is taken into account only to the extent that an annual deferral is made for a participant under an eligible plan as a result of plan provisions permitted under Sec. 1.457-4(c)(3). In addition, if a participant has annual deferrals under more than one eligible plan and the applicable catch-up amount under Sec. 1.457-4(c)(2) or (3) is not the same for each such eligible plan for the taxable year, section 457(c) and this section are applied using the catch-up amount under whichever plan has the largest catch-up amount applicable to the participant.

(d) Examples. The provisions of this section are illustrated by the following examples:

Example 1. (i) Facts. Participant F is age 62 in 2006 and participates in two eligible plans during 2006, Plans J and K, which are each eligible plans of two different governmental entities. Each plan includes provisions allowing the maximum annual deferral permitted under Sec. 1.457-4(c)(1) through (3). For 2006, the underutilized amount under Sec. 1.457-4(c)(3)(ii)(B) is \$20,000 under Plan J and is \$40,000 under Plan K. Normal retirement age is age 65 under both plans. Participant F defers \$15,000 under each plan. Participant F's includible compensation is in each case in excess of the deferral. Neither plan designates the \$15,000 contribution as a catch-up permitted under each plan's special section 457 catch-up provisions.

(ii) Conclusion. For purposes of applying this section to Participant F for 2006, the maximum exclusion is \$20,000. This is

equal to the sum of \$15,000 plus \$5,000, which is the age 50 catch-up amount. Thus, F has an excess amount of \$10,000 which is treated as an excess deferral for Participant F for 2006 under Sec. 1.457-4(e).

Example 2. (i) Facts. Participant E, who will turn 63 on April 1, 2006, participates in four eligible plans during 2006: Plan W which is an eligible governmental plan; and Plans X, Y, and Z which are each eligible plans of three different tax-exempt entities. For 2006, the limitation under these plans that apply to Participant E under all four plans under Sec. 1.457-4(c)(1)(i)(A) is \$15,000. For 2006, the additional age 50 catch-up limitation that applies to Participant E under Plan W under Sec. 1.457-4(c)(2) is \$5,000. Further, for 2006, different limitations under Secs. 1.457-4(c)(3) and (c)(3)(ii)(B) apply to Participant E under each of these plans, as follows: Under Plan W, the underutilized limitation under Sec. 1.457-4(c)(3)(ii)(B) is \$7,000; under Plan X, the underutilized limitation under Sec. 1.457-4(c)(3)(ii)(B) is \$2,000; under Plan Y, the underutilized limitation under Sec. 1.457-4(c)(3)(ii)(B) is \$8,000; and under Plan Z, Sec. 1.457-4(c)(3) is not applicable since normal retirement age is age 62 under Plan Z. Participant E's includible compensation is in each case in excess of any applicable deferral.

(ii) Conclusion. For purposes of applying this section to Participant E for 2006, Participant E could elect to defer \$23,000 under Plan Y, which is the maximum deferral limitation under Secs. 1.457-4(c)(1) through (3), and to defer no amount under Plans W, X, and Z. The \$23,000 maximum amount is equal to the sum of \$15,000 plus \$8,000, which is the catch-up amount applicable to Participant E under Plan Y and which is the largest catch-up amount applicable to Participant E under any of the four plans for 2006. Alternatively, Participant E could instead elect to defer the following combination of amounts: \$5,000 to Plan W and an aggregate total of \$15,000 to Plans X, Y, and Z; \$22,000 to Plan W and none to any of the other three plans; \$17,000 to Plan X and none to any of the other three plans; or \$15,000 to Plan Z and none to any of the other three plans.

(iii) If the underutilized amount under Plans W, X, and Y for 2006 were in each case zero (because E had always contributed the maximum amount or E was a new participant) or an amount not in excess of \$5,000, the maximum exclusion under this section would be \$20,000 for Participant E for 2006 (\$15,000 plus the \$5,000 age 50 catch-up amount), which Participant E could contribute to Plan W.

Sec. 1.457-6 Timing of distributions under eligible plans.

(a) In general. Except as provided in paragraph (c) of this section (relating to distributions on account of an unforeseeable emergency), paragraph (e) of this section (relating to distributions of small accounts), Sec. 1.457-10(a) (relating to plan terminations), or Sec. 1.457-10(c) (relating to domestic relations orders), amounts deferred under an eligible governmental plan may not be paid to a participant or beneficiary before the participant has a severance from employment with the eligible employer. For rules relating to loans, see paragraph (f) of this section.

(b) Severance from employment--(1) Employees. An employee has a severance from employment with the eligible employer if the employee dies, retires, or otherwise has a severance from employment with the eligible employer.

(2) Independent contractors--(i) In general. An independent contractor is considered to have a severance from employment with the eligible employer upon the expiration of the contract (or in the case of more than one contract, all contracts) under which services are performed for the eligible employer, if the expiration constitutes a good-faith and complete termination of the contractual relationship. An expiration does not constitute a good faith and complete termination of the contractual relationship if the eligible employer anticipates a renewal of a contractual relationship or the independent contractor becoming an employee. For this purpose, an eligible employer is considered to anticipate the renewal of the contractual relationship with an independent contractor if it intends to again contract for the services provided under the expired contract, and neither the eligible employer nor the independent contractor has eliminated the independent contractor as a possible provider of services under any such new contract. Further, an eligible employer is considered to intend to again contract for the services provided under an expired contract if the eligible employer's doing so is conditioned only upon incurring a need for the services, the availability of funds, or both.

(ii) Special rule. Notwithstanding paragraph (b)(2)(i) of this section, the plan is considered to satisfy the requirement described in paragraph (a) of this section that no amounts deferred under the plan be paid or made available to the participant before the participant has a severance from employment with the eligible employer, if, with respect to amounts payable to a participant who is an independent contractor, an eligible plan provides that--

(A) No amount will be paid to the participant before a date at least 12 months after the day on which the contract expires under which services are performed for the eligible employer (or, in the case of more than one contract, all such contracts expire); and

(B) No amount payable to the participant on that date will be paid to the participant if, after the expiration of the contract (or contracts) and before that date, the participant performs services for the eligible employer as an independent contractor or an employee.

(c) Rules applicable to distributions for unforeseeable emergencies--(1) In general. An eligible plan may permit a distribution to a participant or beneficiary faced with an unforeseeable emergency. The distribution must satisfy the requirement of paragraph (c)(2) of this section.

(2) Requirements--(i) Unforeseeable emergency defined. An unforeseeable emergency must be defined in the plan as a severe financial hardship of the participant or beneficiary resulting from an illness or accident of the participant or beneficiary, the participant's or beneficiary's spouse or the participant's or beneficiary's dependent (as defined in section 152(a)); loss of the participant's or beneficiary's property due to casualty; or other similar extraordinary and unforeseeable circumstances arising as a result of events beyond the control of the participant or the beneficiary. For example, the imminent foreclosure of or eviction from the participant's or beneficiary's primary residence may constitute an unforeseeable emergency. In addition, the need to pay for medical expenses, including non-refundable deductibles, as well as for the cost of prescription drug medication, may constitute an unforeseeable emergency. Finally, the need to pay for the funeral expenses of a family member may also constitute an unforeseeable emergency. Except in extraordinary circumstances, the purchase of a home and the payment of college tuition are not unforeseeable emergencies under this paragraph (c)(2).

(ii) Unforeseeable emergency distribution standard. Whether a participant or beneficiary is faced with an unforeseeable emergency permitting a distribution under this paragraph (c) is to be determined based on the relevant facts and circumstances of each case, but, in any case, a distribution on account of unforeseeable emergency may not be made to the extent that such emergency is or may be relieved through reimbursement or compensation from insurance or otherwise; by liquidation of the participant's assets, to the extent the liquidation of such assets would not itself cause severe financial hardship; or by cessation of deferrals under the plan.

(iii) Distribution necessary to satisfy emergency need. Distributions because of an unforeseeable emergency must be limited to the amount reasonably necessary to satisfy the emergency need (which may include any amounts necessary to pay any federal, state, or local income taxes or penalties reasonably anticipated to result from the distribution).

(d) Minimum required distributions for eligible plans. In order to be an eligible plan, a plan must meet the distribution requirements of section 457(d)(1) and (2). Under section 457(d)(2), a plan must meet

the minimum distribution requirements of section 401(a)(9). See section 401(a)(9) and the regulations thereunder for these requirements. Section 401(a)(9) requires that a plan begin lifetime distributions to a participant no later than April 1 of the calendar year following the later of the calendar year in which the participant attains age 70½ or the calendar year in which the participant retires.

(e) Distributions of smaller accounts--(1) In general. An eligible plan may provide for a distribution of all or a portion of a dollar amount which is not attributable to rollover contributions (as defined in section 411(a)(11)(D)). In order to permit such a distribution, an eligible plan must provide that the amount of the distribution must not exceed the dollar limit under section 411(a)(11)(A) (which is \$5,000 for 2002) and that the distribution is made only if no amount has been deferred under the plan by or for the participant during the two-year period ending on the date of the distribution and there has been no prior distribution under the plan to the participant under this paragraph (e). An eligible plan is not required to permit distributions under this paragraph (e).

(2) Alternative provisions possible. Consistent with the provisions of paragraph (e)(1) of this section, a plan may provide that the total amount deferred for a participant or beneficiary, if not in excess of the applicable dollar limit of section 411(a)(11)(A), will be distributed automatically to the participant or beneficiary if the requirements of paragraph (e)(1) of this section are met. Alternatively, the plan may provide for the total amount deferred for a participant or beneficiary, if not in excess of the applicable dollar limit of section 411(a)(11)(A), to be distributed to the participant or beneficiary only if the participant or beneficiary so elects. The plan is permitted to substitute a specified dollar amount that is less than the applicable dollar limit of section 411(a)(11)(A) under either of these alternatives. In addition, these two alternatives can be combined; for example, a plan could provide for automatic distributions for account balances totaling an amount not in excess of the applicable dollar limit of section 411(a)(11)(A) but allow participants or beneficiary to elect a distribution if the total account balance is above \$500 but not above the applicable dollar limit of section 411(a)(11)(A).

(f) Loans from eligible plans--(1) Eligible plans of tax-exempt entities. If a participant or beneficiary receives (directly or indirectly) any amount deferred as a loan from an eligible plan of a tax-exempt entity, that amount will be treated as having been paid or made available to the individual as a distribution under the plan, in violation of the distribution requirements of section 457(d).

(2) Eligible governmental plans. The determination of whether the availability of a loan, the making of a loan, or a failure to repay a loan made from a trustee (or a person treated as a trustee under

section 457(g)) of an eligible governmental plan to a participant or beneficiary is treated as a distribution (directly or indirectly) for purposes of this section, and the determination of whether the availability of the loan, the making of the loan, or a failure to repay the loan is in any other respect a violation of the requirements of section 457(b) and the regulations, depends on the facts and circumstances. Thus, for example, a loan must bear a reasonable rate of interest in order to satisfy the exclusive benefit requirement of section 457(g)(1) and Sec. 1.457-8(a)(1). See also Sec. 1.457-7(b)(3) relating to the application of section 72(p) with respect to the taxation of a loan made under an eligible governmental plan, and Sec. 1.72(p)-1 relating to section 72(p)(2).

(3) Example. The provisions of paragraph (f)(2) of this section are illustrated by the following example:

Example. (i) Facts. Eligible Plan X of State Y is funded through Trust Z. Plan X provides for an employee's account balance under Plan X to be paid in 5 annual installments (of $\frac{1}{5}$ th the account balance the first year, $\frac{1}{4}$ th the account balance the second year, etc.) beginning at severance from employment with State Y. Plan X includes a loan program under which any active employee with a vested account balance may receive a loan from Trust Z. Loans are made pursuant to plan provisions regarding loans that are set forth in the plan under which loans bear a reasonable rate of interest and are secured by the employee's account balance. In order to avoid taxation under Sec. 1.457-7(b)(3) and section 72(p)(1), the plan provisions limit the amount of loans and require loans to be repaid in level installments as required under section 72(p)(2).

Participant J's vested account balance under Plan X is \$50,000. J receives a loan from Trust Z in the amount of \$5,000 on December 1, 2003 to be repaid in level installments made quarterly over the 5-year period ending on November 30, 2008. Participant J makes the required repayments until J has a severance from employment from State Y in 2005 and subsequently fails to repay the outstanding loan balance of \$2,250. The \$2,250 loan balance is offset against J's \$80,000 account balance benefit under Plan X, and J is paid one fifth of the remaining \$77,750 in 2005.

(ii) Conclusion. The making of the loan to J will not be treated as a violation of the requirements of section 457(b) or the regulations. The cancellation of the loan at severance from employment does not cause Plan X to fail to satisfy the requirements for plan eligibility under section 457. In addition, because the loan satisfies the maximum amount and repayment requirements of section 72(p)(2), J is not required to include any amount in income as a result of the loan until 2005, when J has income of \$2,250 as a result of the offset (which is a permissible distribution under this

section) and income of \$15,550 (one fifth of \$77,750) as a result of the first annual installment payment.

Sec. 1.457-7 Taxation of distributions under eligible plans.

(a) General rules for when amounts are included in gross income. The rules for determining when an amount deferred under an eligible plan is includible in the gross income of a participant or beneficiary depend on whether the plan is an eligible governmental plan or an eligible plan of a tax-exempt entity. Paragraph (b) of this section sets forth the rules for an eligible governmental plan. Paragraph (c) of this section sets forth the rules for an eligible plan of a tax-exempt entity.

(b) Amounts included in gross income under an eligible governmental plan--(1) Amounts included in gross income in year paid under an eligible governmental plan. Except as provided in paragraphs (b)(2) and (3) of this section (or in Sec. 1.457-10(c) relating to payments to a spouse or former spouse pursuant to a qualified domestic relations order), amounts deferred under an eligible governmental plan are includible in the gross income of a participant or beneficiary for the taxable year in which paid to the participant or beneficiary under the plan.

(2) Rollovers to individual retirement arrangements and other eligible retirement plans. A trustee-to-trustee transfer in accordance with section 401(a)(31) (generally referred to as a direct rollover) is not includible in gross income of a participant or beneficiary in the year transferred. In addition, any payment made in the form of an eligible rollover distribution (as defined in section 402(c)(4)) is not includible in gross income in the year paid to the extent the payment is transferred to an eligible retirement plan (as defined in section 402(c)(8)(B)) within 60 days, including the transfer to the eligible retirement plan of any property distributed from the eligible governmental plan. For this purpose, the rules of section 402(c)(2) through (7) and (9) apply. Any trustee-to-trustee transfer under this paragraph (b)(2) is a distribution that is subject to the distribution requirements of Sec. 1.457-6.

(3) Amounts taxable under section 72(p)(1). In accordance with section 72(p), the amount of any loan from an eligible governmental plan to a participant or beneficiary (including any pledge or assignment treated as a loan under section 72(p)(1)(B)) is treated as having been received as a distribution from the plan under section 72(p)(1), except to the extent set forth in section 72(p)(2) (relating to loans that do not exceed a maximum amount and that are repayable in accordance with certain terms) and Sec. 1.72(p)-1. Thus, except to the extent a loan satisfies section 72(p)(2), any amount loaned from an eligible governmental plan to a participant or beneficiary (including

any pledge or assignment treated as a loan under section 72(p)(1)(B)) is includible in the gross income of the participant or beneficiary for the taxable year in which the loan is made. See generally Sec. 1.72(p)-1.

(4) Examples. The provisions of this paragraph (b) are illustrated by the following examples:

Example 1. (i) Facts. Eligible Plan G of a governmental entity permits distribution of benefits in a single sum or in installments of up to 20 years, with such benefits to commence at any date that is after severance from employment (but not later than the plan's normal retirement age of 65). Effective for participants who have a severance from employment after December 31, 2001, Plan X allows an election--as to both the date on which payments are to begin and the form in which payments are to be made--to be made by the participant at any time that is before the commencement date selected. However, Plan X chooses to require elections to be **filed** at least 30 days before the commencement date selected in order for Plan X to have enough time to be able to effectuate the election.

(ii) Conclusion. No amounts are included in gross income before actual payments begin. If installment payments begin (and the installment payments are payable over at least 10 years so as not to be eligible rollover distributions), the amount included in gross income for any year is equal to the amount of the installment payment paid during the year.

Example 2. (i) Facts. Same facts as in Example 1, except that the same rules are extended to participants who had a severance from employment before January 1, 2002.

(ii) Conclusion. For all participants (i.e., both those who have a severance from employment after December 31, 2001 and those who have a severance from employment before January 1, 2002 (including those whose benefit payments have commenced before January 1, 2002)), no amounts are included in gross income before actual payments begin. If installment payments begin (and the installment payments are payable over at least 10 years so as not to be eligible rollover distributions), the amount included in gross income for any year is equal to the amount of the installment payment paid during the year.

(c) Amounts included in gross income under an eligible plan of a tax-exempt entity--(1) Amounts included in gross income in year paid or made available under an eligible plan of a tax-exempt entity. Amounts deferred under an eligible plan of a tax-exempt entity are includible in the gross income of a participant or beneficiary for the taxable year in which paid or otherwise made available to the participant or beneficiary under the plan. Thus, amounts deferred under an eligible

plan of a tax-exempt entity are includible in the gross income of the participant or beneficiary in the year the amounts are first made available under the terms of the plan, even if the plan has not distributed the amounts deferred. Amounts deferred under an eligible plan of a tax-exempt entity are not considered made available to the participant or beneficiary solely because the participant or beneficiary is permitted to choose among various investments under the plan.

(2) When amounts deferred are considered to be made available under an eligible plan of a tax-exempt entity--(i) General rule. Except as provided in paragraphs (c)(2)(ii) through (iv) of this section, amounts deferred under an eligible plan of a tax-exempt entity are considered made available (and, thus, are includible in the gross income of the participant or beneficiary under this paragraph (c)) at the earliest date, on or after severance from employment, on which the plan allows distributions to commence, but in no event later than the date on which distributions must commence pursuant to section 401(a)(9). For example, in the case of a plan that permits distribution to commence on the date that is 60 days after the close of the plan year in which the participant has a severance from employment with the eligible employer, amounts deferred are considered to be made available on that date. However, distributions deferred in accordance with paragraphs (c)(2)(ii) through (iv) of this section are not considered made available prior to the applicable date under paragraphs (c)(2)(ii) through (iv) of this section. In addition, no portion of a participant or beneficiary's account is treated as made available (and thus currently includible in income) under an eligible plan of a tax-exempt entity merely because the participant or beneficiary under the plan may elect to receive a distribution in any of the following circumstances:

(A) If the requirements of Sec. 1.457-4(d) are met, a distribution of amounts representing accumulated sick and vacation pay solely because a participant was entitled to take paid sick or vacation leave in lieu of regular compensation or because the participant could have deferred these amounts under an eligible plan at an earlier date. However, to the extent that the participant is able to receive the value of accumulated sick and vacation pay in cash (in addition to regular compensation) at the time of the election to defer, these amounts are considered made available.

(B) If the requirements of Sec. 1.457-6(c)(2) are met, a distribution in the event of an unforeseeable emergency.

(C) If the requirements of Sec. 1.457-6(e)(1) are met, a distribution not in excess of the dollar limit under section 411(a)(11)(A) (which is \$5,000 for 2002) either before or after the participant has a severance from employment with the employer.

(ii) Initial election to defer commencement of distributions--(A)

In general. An eligible plan of a tax-exempt entity may provide a period for making an initial election during which the participant or beneficiary may elect, in accordance with the terms of the plan, to defer the payment of some or all of the amounts deferred to a fixed or determinable future time. The period for making this initial election must expire prior to the first time that any such amounts would be considered made available under the plan under paragraph (c)(2)(i) of this section.

(B) Failure to make initial election to defer commencement of distributions. Generally, if no initial election is made by a participant or beneficiary under this paragraph (c)(2)(ii), then the amounts deferred under an eligible plan of a tax-exempt entity are considered made available and taxable to the participant or beneficiary in accordance with paragraph (c)(2)(i) of this section at the earliest time, on or after severance from employment (but in no event later than the date on which distributions must commence pursuant to section 401(a)(9)), that distribution is permitted to commence under the terms of the plan. However, the plan may provide for a default payment schedule that applies if no election is made. If the plan provides for a default payment schedule, the amounts deferred are includible in the gross income of the participant or beneficiary in the year the amounts deferred are first made available under the terms of the default payment schedule.

(iii) Additional election to defer commencement of distribution. An eligible plan of a tax-exempt entity is permitted to provide that a participant or beneficiary who has made an initial election under paragraph (c)(2)(ii)(A) of this section may make one additional election to defer (but not accelerate) commencement of distributions under the plan before distributions have commenced in accordance with the initial deferral election under paragraph (c)(2)(ii)(A) of this section. Amounts payable to a participant or beneficiary under an eligible plan of a tax-exempt entity are not treated as made available merely because the plan allows the participant to make an additional election under this paragraph (c)(2)(iii). A participant or beneficiary is not precluded from making an additional election to defer commencement of distributions merely because the participant or beneficiary has previously received a distribution under Sec. 1.457-6(c) because of an unforeseeable emergency, has received a distribution of smaller amounts under Sec. 1.457-6(e), has made (and revoked) other deferral or method of payment elections within the initial election period, or is subject to a default payment schedule under which the commencement of benefits is deferred (for example, until a participant is age 65).

(iv) Election as to method of payment. An eligible plan of a tax-exempt entity may provide that the election as to the method of payment under the plan may be made at any time prior to the time the amounts are distributed in accordance with the participant or beneficiary's

initial or additional election to defer commencement of distributions under paragraph (c)(2)(ii) or (iii) of this section. Where no method of payment is elected, the entire amount deferred will be includible in the gross income of the participant or beneficiary when the amounts first become made available in accordance with a participant's initial or additional elections to defer under paragraphs (c)(2)(ii) and (iii) of this section, unless the eligible plan provides for a default method of payment (in which case amounts are considered made available and taxable when paid under the terms of the default payment schedule).

(3) Examples. The provisions of this paragraph (c) are illustrated by the following examples:

Example 1. (i) Facts. Eligible Plan X of a tax-exempt entity provides that a participant's total account balance, representing all amounts deferred under the plan, is payable to a participant in a single sum 60 days after severance from employment throughout these examples, unless, during a 30-day period immediately following the severance, the participant elects to receive the single sum payment at a later date (that is not later than the plan's normal retirement age of 65) or elects to receive distribution in 10 annual installments to begin 60 days after severance from employment (or at a later date, if so elected, that is not later than the plan's normal retirement age of 65). On November 13, 2002, participant K, a calendar year taxpayer, has a severance from employment with the eligible employer. K does not, within the 30-day window period, elect to postpone distributions to a later date or to receive payment in 10 fixed annual installments.

(ii) Conclusion. The single sum payment is payable to K 60 days after the date K has a severance from employment (January 12, 2003), and is includible in the gross income of K in 2003 under section 457(a).

Example 2. (i) Facts. The terms of eligible Plan X are the same as described in Example 1. Participant L participates in eligible Plan X. On November 11, 2002, participant L has a severance from the employment of the eligible employer. On November 24, 2002, L makes an initial deferral election not to receive the single sum payment payable 60 days after the severance, and instead elects to receive the amounts in 10 annual installments to begin 60 days after severance from employment.

(ii) Conclusion. No portion of L's account is considered made available in 2002 or 2003 before a payment is made and no amount is includible in the gross income of L until distributions commence. The annual installment payable in 2003 will be includible in L's gross income in 2003.

Example 3. (i) Facts. The facts are the same as in Example 1, except that eligible Plan X also provides that those participants

who are receiving distributions in 10 annual installments may, at any time and without restriction, elect to receive a cash out of all remaining installments. Participant M elects to receive a distribution in 10 annual installments commencing in 2003.

(ii) Conclusion. M's total account balance, representing the total of the amounts deferred under the plan, is considered made available in, and is includible in M's gross income, in 2003.

Example 4. (i) Facts. The facts are the same as in Example 3, except that, instead of providing for an unrestricted cash out of remaining payments, the plan provides that participants or beneficiaries who are receiving distributions in 10 annual installments may accelerate the payment of the amount remaining payable to the participant upon the occurrence of an unforeseeable emergency as described in Sec. 1.457-6(c)(1) in an amount not exceeding that described in Sec. 1.457-6(c)(2).

(ii) Conclusion. No amount is considered made available to participant M on account of M's right to accelerate payments upon the occurrence of an unforeseeable emergency.

Example 5. (i) Facts. Eligible Plan Y of a tax-exempt entity provides that distributions will commence 60 days after a participant's severance from employment unless the participant elects, within a 30-day window period following severance from employment, to defer distributions to a later date (but no later than the year following the calendar year the participant attains age 70½). The plan provides that a participant who has elected to defer distributions to a later date may make an election as to form of distribution at any time prior to the 30th day before distributions are to commence.

(ii) Conclusion. No amount is considered made available prior to the date distributions are to commence by reason of a participant's right to defer or make an election as to the form of distribution.

Example 6. (i) Facts. The facts are the same as in Example 1, except that the plan also permits participants who have earlier made an election to defer distribution to make one additional deferral election at any time prior to the date distributions are scheduled to commence. Participant N has a severance from employment at age 50. The next day, during the 30-day period provided in the plan, N elects to receive distribution in the form of 10 annual installment payments beginning at age 55. Two weeks later, within the 30-day window period, N makes a new election permitted under the plan to receive 10 annual installment payments beginning at age 60 (instead of age 55). When N is age 59, N elects under the additional deferral election provisions, to defer distributions until age 65.

(ii) Conclusion. In this example, N's election to defer distributions until age 65 is a valid election. The two elections N makes during the 30-day window period are not additional deferral

elections described in paragraph (c)(2)(iii) of this section because they are made before the first permissible payout date under the plan. Therefore, the plan is not precluded from allowing N to make the additional deferral election. However, N can make no further election to defer distributions beyond age 65 because this additional deferral election can only be made once.

Sec. 1.457-8 Funding rules for eligible plans.

(a) Eligible governmental plans--(1) In general. In order to be an eligible governmental plan, all amounts deferred under the plan, all property and rights purchased with such amounts, and all income attributable to such amounts, property, or rights, must be held in trust for the exclusive benefit of participants and their beneficiaries. A trust described in this paragraph (a) that also meets the requirements of Secs. 1.457-3 through 1.457-10 is treated as an organization exempt from tax under section 501(a), and a participant's or beneficiary's interest in amounts in the trust is includible in the gross income of the participants and beneficiaries only to the extent, and at the time, provided for in section 457(a) and Secs. 1.457-4 through 1.457-10.

(2) Trust requirement. (i) A trust described in this paragraph (a) must be established pursuant to a written agreement that constitutes a valid trust under state law. The terms of the trust must make it impossible, prior to the satisfaction of all liabilities with respect to participants and their beneficiaries, for any part of the assets and income of the trust to be used for, or diverted to, purposes other than for the exclusive benefit of participants and their beneficiaries.

(ii) Amounts deferred under an eligible governmental plan must be transferred to a trust within a period that is not longer than is reasonable for the proper administration of the participant accounts (if any). For purposes of this requirement, the plan may provide for amounts deferred for a participant under the plan to be transferred to the trust within a specified period after the date the amounts would otherwise have been paid to the participant. For example, the plan could provide for amounts deferred under the plan to be contributed to the trust within 15 business days following the month in which these amounts would otherwise have been paid to the participant.

(3) Custodial accounts and annuity contracts treated as trusts--(i) In general. For purposes of the trust requirement of this paragraph (a), custodial accounts and annuity contracts described in section 401(f) that satisfy the requirements of this paragraph (a)(3) are treated as trusts under rules similar to the rules of section 401(f). Therefore, the provisions of Sec. 1.401(f)-1(b) will generally apply to determine whether a custodial account or an annuity contract is treated

as a trust. The use of a custodial account or annuity contract as part of an eligible governmental plan does not preclude the use of a trust or another custodial account or annuity contract as part of the same plan, provided that all such vehicles satisfy the requirements of section 457(g)(1) and (3) and paragraphs (a)(1) and (2) of this section and that all assets and income of the plan are held in such vehicles.

(ii) Custodial accounts--(A) In general. A custodial account is treated as a trust, for purposes of section 457(g)(1) and paragraph (a)(1) and (2) of this section, if the custodian is a bank, as described in section 408(n), or a person who meets the nonbank trustee requirements of paragraph (a)(3)(ii)(B) of this section, and the account meets the requirements of paragraphs (a)(1) and (2) of this section, other than the requirement that it be a trust.

(B) Nonbank trustee status. The custodian of a custodial account may be a person other than a bank only if the person demonstrates to the satisfaction of the Commissioner that the manner in which the person will administer the custodial account will be consistent with the requirements of section 457(g)(1) and (3). To do so, the person must demonstrate that the requirements of Sec. 1.408-2(e)(2) through (6) (relating to nonbank trustees) are met. The written application must be sent to the address prescribed by the Commissioner in the same manner as prescribed under Sec. 1.408-2(e). To the extent that a person has already demonstrated to the satisfaction of the Commissioner that the person satisfies the requirements of Sec. 1.408-2(e) in connection with a qualified trust (or custodial account or annuity contract) under section 401(a), that person is deemed to satisfy the requirements of this paragraph (a)(3)(ii)(B).

(iii) Annuity contracts. An annuity contract is treated as a trust for purposes of section 457(g)(1) and paragraph (a)(1) of this section if the contract is an annuity contract, as defined in section 401(g), that has been issued by an insurance company qualified to do business in the State, and the contract meets the requirements of paragraphs (a)(1) and (2) of this section, other than the requirement that it be a trust. An annuity contract does not include a life, health or accident, property, casualty, or liability insurance contract.

(4) Combining assets. [Reserved]

(b) Eligible plans maintained by tax-exempt entity--(1) General rule. In order to be an eligible plan of a tax-exempt entity, the plan must be unfunded and plan assets must not be set aside for participants or their beneficiaries. Under section 457(b)(6) and this paragraph (b), an eligible plan of a tax-exempt entity must provide that all amounts deferred under the plan, all property and rights to property (including rights as a beneficiary of a contract providing life insurance protection) purchased with such amounts, and all income attributable to such amounts, property, or rights, must remain (until paid or made available to the participant or beneficiary) solely the property and

rights of the eligible employer (without being restricted to the provision of benefits under the plan), subject only to the claims of the eligible employer's general creditors.

(2) Additional requirements. For purposes of paragraph (b)(1) of this section, the plan must be unfunded regardless of whether or not the amounts were deferred pursuant to a salary reduction agreement between the eligible employer and the participant. Any funding arrangement under an eligible plan of a tax-exempt entity that sets aside assets for the exclusive benefit of participants violates this requirement, and amounts deferred are generally immediately includible in the gross income of plan participants and beneficiaries. Nothing in this paragraph (b) prohibits an eligible plan from permitting participants and their beneficiaries to make an election among different investment options available under the plan, such as an election affecting the investment of the amounts described in paragraph (b)(1) of this section.

Sec. 1.457-9 Effect on eligible governmental plan when not administered in accordance with eligibility requirements.

A plan of a state ceases to be an eligible governmental plan on the first day of the first plan year beginning more than 180 days after the date on which the Commissioner notifies the state in writing that the plan is being administered in a manner that is inconsistent with one or more of the requirements of Secs. 1.457-3 through 1.457-8, or 1.457-10. However, the plan may correct the plan inconsistencies specified in the written notification before the first day of that plan year and continue to maintain plan eligibility. If a plan ceases to be an eligible governmental plan, amounts subsequently deferred by participants will be includible in income when deferred, or, if later, when the amounts deferred cease to be subject to a substantial risk of forfeiture, as provided at Sec. 1.457-11. Amounts deferred before the date on which the plan ceases to be an eligible governmental plan, and any earnings thereon, will be treated as if the plan continues to be an eligible governmental plan and will not be includible in participant's or beneficiary's gross income until paid to the participant or beneficiary.

Sec. 1.457-10 Miscellaneous provisions.

(a) Plan terminations and frozen plans--(1) In general. An eligible employer may amend its plan to eliminate future deferrals for existing participants or to limit participation to existing participants and employees. An eligible plan may also contain provisions that permit plan termination and permit amounts deferred to be distributed on

termination. In order for a plan to be considered terminated, amounts deferred under an eligible plan must be distributed to all plan participants and beneficiaries as soon as administratively practicable after termination of the eligible plan. The mere provision for, and making of, distributions to participants or beneficiaries upon a plan termination will not cause an eligible plan to cease to satisfy the requirements of section 457(b) of the regulations.

(2) Employers that cease to be eligible employers--(i) Plan not terminated. An eligible employer that ceases to be an eligible employer may no longer maintain an eligible plan. If the employer was a tax-exempt entity and the plan is not terminated as permitted under paragraph (a)(2)(ii) of this section, the tax consequences to participants and beneficiaries in the previously eligible (unfunded) plan of an ineligible employer will be determined in accordance with either section 451 if the employer becomes an entity other than a state or Sec. 1.457-11 if the employer becomes a state. If the employer was a state and the plan is neither terminated as permitted under paragraph (a)(2)(ii) of this section nor transferred to another eligible plan of that state as permitted under paragraph (b) of this section, the tax consequences to participants in the previously eligible governmental plan of an ineligible employer, the assets of which are held in trust pursuant to Sec. 1.457-8(a), will be determined in accordance with section 402(b) (section 403(c) in the case of an annuity contract) and the trust will no longer be treated as a trust that is exempt from tax under section 501(a).

(ii) Plan termination. As an alternative to determining the tax consequences to the plan and participants under paragraph (a)(2)(i) of this section, the employer may terminate the plan and distribute the amounts deferred (and all plan assets) to all plan participants as soon as administratively practicable in accordance with paragraph (a)(1) of this section. Such distribution may include eligible rollover distributions in the case of a plan that was an eligible governmental plan. In addition, if the employer is a state, another alternative to determining the tax consequences under paragraph (a)(2)(i) of this section is to transfer the assets of the eligible governmental plan to an eligible governmental plan of another eligible employer within the same state under the plan-to-plan transfer rules of paragraph (b) of this section.

(3) Examples. The provisions of this paragraph (a) are illustrated by the following examples:

Example 1. (i) Facts. Employer Y, a corporation that owns a state hospital, sponsors an eligible governmental plan funded through a trust. Employer Y is acquired by a for-profit hospital and Employer Y ceases to be an eligible employer under section 457(e)(1) or Sec. 1.457-2(e). Employer Y terminates the plan and, during the

next 6 months, distributes to participants and beneficiaries all amounts deferred that were under the plan.

(ii) Conclusion. The termination and distribution does not cause the plan to fail to be an eligible governmental plan. Amounts that are distributed as eligible rollover distributions may be rolled over to an eligible retirement plan described in section 402(c)(8)(B).

Example 2. (i) Facts. The facts are the same as in Example 1, except that Employer Y decides to continue to maintain the plan.

(ii) Conclusion. If Employer Y continues to maintain the plan, the tax consequences to participants and beneficiaries with respect to compensation deferred thereafter will be determined in accordance with either section 402(b) if the compensation deferred is funded through a trust, section 403(c) if the compensation deferred is funded through annuity contracts, or Sec. 1.457-11 if the compensation deferred is not funded through a trust or annuity contract. In addition, if Employer Y continues to maintain the plan, the trust (including amounts deferred before the date on which the plan ceases to be an eligible governmental plan and any earnings thereon) will no longer be treated as exempt from tax under section 501(a).

Example 3. (i) Facts. Employer Z, a corporation that owns a tax-exempt hospital, sponsors an unfunded eligible plan. Employer Z is acquired by a for-profit hospital and is no longer an eligible employer under section 457(e)(1) or Sec. 1.457-2(e). Employer Z terminates the plan and distributes all amounts deferred under the eligible plan to participants and beneficiaries within a one-year period.

(ii) Conclusion. Distributions under the plan are treated as made under an eligible plan of a tax-exempt entity and the distributions of the amounts deferred are includible in the gross income of the participant or beneficiary in the year distributed.

Example 4. (i) Facts. The facts are the same as in Example 3, except that Employer Z decides to maintain instead of terminate the plan.

(ii) Conclusion. If Employer Z maintains the plan, the tax consequences to participants and beneficiaries in the plan will thereafter be determined in accordance with section 451.

(b) Plan-to-plan transfers--(1) General rule. An eligible governmental plan may provide for the transfer of amounts deferred by a participant or beneficiary to another eligible governmental plan, and an eligible plan of a tax-exempt entity may provide for transfers of amounts deferred by a participant to another eligible plan of a tax-exempt entity, if the conditions in paragraph (b)(2) of this section are met. An eligible governmental plan may accept transfers from

another eligible governmental plan as described in the preceding sentence, and an eligible plan of a tax-exempt entity may accept transfers from another eligible plan of a tax-exempt entity as described in the preceding sentence. However, a state may not transfer the assets of its eligible governmental plan to a tax-exempt entity's eligible plan and the plan of a tax-exempt entity may not accept such a transfer. Similarly, a tax-exempt entity may not transfer the assets of its eligible plan to an eligible governmental plan and an eligible governmental plan may not accept such a transfer. In addition, if the conditions in paragraph (b)(4) of this section (relating to permissive past service credit and repayments under section 415) are met, an eligible governmental plan of a state may provide for the transfer of amounts deferred by a participant or beneficiary to a qualified plan (under section 401(a)) maintained by a state. However, a qualified plan may not transfer assets to an eligible governmental plan or to an eligible plan of a tax-exempt entity, and an eligible governmental plan or the plan of a tax-exempt entity may not accept such a transfer.

(2) Requirements for plan-to-plan transfers among eligible plans. A transfer under paragraph (b)(1) of this section from an eligible governmental plan to another eligible governmental plan is permitted only if the following conditions are met--

- (i) The transferor plan provides for transfers;
- (ii) The receiving plan provides for the receipt of transfers;
- (iii) The participant or beneficiary whose amounts deferred are being transferred will have an amount deferred immediately after the transfer at least equal to the amount deferred with respect to that participant or beneficiary immediately before the transfer; and
- (iv) The participant or beneficiary whose amounts deferred are being transferred has had a severance from employment with the transferring employer and is performing services for the entity maintaining the receiving plan. However, this paragraph (b)(2)(iv) is not required to be satisfied if--

(A) All of the assets held by the eligible governmental plan are transferred;

(B) The transfer is to another eligible governmental plan maintained by an eligible employer that is a state entity within the same state; and

(C) The participants whose deferred amounts are being transferred are not eligible for additional annual deferrals in the receiving plan unless they are performing services for the entity maintaining the receiving plan.

(3) Examples. The provisions of paragraphs (b)(1) and (2) of this section are illustrated by the following examples:

Example 1. (i) Facts. Participant A, the president of City X's hospital, has accepted a position with another hospital which is a

tax-exempt entity. A participates in the eligible governmental plan of City X. A would like to transfer the amounts deferred under City X's eligible governmental plan to the eligible plan of the tax-exempt hospital.

(ii) Conclusion. City X's plan may not transfer A's amounts deferred to the tax-exempt employer's eligible plan. In addition, because the amounts deferred would no longer be held in trust for the exclusive benefit of participants and their beneficiaries, the transfer would violate the exclusive benefit rule of section 457(g) and Sec. 1.457-8(a).

Example 2. (i) Facts. County M, located in State S, operates several health clinics and maintains an eligible governmental plan for employees of those clinics. One of the clinics operated by County M is being acquired by a hospital operated by State S, and employees of that clinic will become employees of State S. County M permits those employees to transfer their balances under County M's eligible governmental plan to the eligible governmental plan of State S.

(ii) Conclusion. If the eligible governmental plans of County M and State S provide for the transfer and acceptance of the transfer (and the other requirements of paragraph (b)(1) of this section are satisfied), the transfer will not cause either plan to violate the requirements of section 457 or these regulations.

Example 3. (i) Facts. City Employer Z, a hospital, sponsors an eligible governmental plan. City Employer Z is located in State B. All of the assets of City Employer Z are being acquired by a tax-exempt hospital. City Employer Z, in accordance with the plan-to-plan transfer rules of paragraph (b) of this section, would like to transfer the total amount of assets deferred under City Employer Z's eligible governmental plan to the acquiring tax-exempt entity's eligible plan.

(ii) Conclusion. City Employer Z may not permit participants to transfer the amounts to the eligible plan of the tax-exempt entity. In addition, because the amounts deferred would no longer be held in trust for the exclusive benefit of participants and their beneficiaries, the transfer would violate the exclusive benefit rule of section 457(g) and Sec. 1.457-8(a).

Example 4. (i) Facts. The facts are the same as in Example 3, except that City Employer Z, prior to the transfer of all of its assets to the eligible plan of the tax-exempt entity, decides to transfer all of the amounts deferred under City Z's eligible governmental plan to the eligible governmental plan of the related state government entity, State B.

(ii) Conclusion. If City Employer Z's (transferor) eligible governmental plan provides for such transfer and the eligible governmental plan of the State B permits the acceptance of such a

transfer (and the other requirements of paragraph (b)(1) of this section are satisfied), City Employer Z may transfer the total amounts deferred under its eligible governmental plan, prior to termination of that plan, to the eligible governmental plan maintained by State B. However, the participants of City Employer Z whose deferred amounts are being transferred are not eligible to participate in the eligible governmental plan of State B, the receiving plan, unless they are performing services for State B.

(4) Purchase of permissive past service credit by plan-to-plan transfers from an eligible governmental plan to a qualified plan--(i) General rule. An eligible governmental plan of a state may provide for the transfer of amounts deferred by a participant or beneficiary to a defined benefit governmental plan (as defined in section 414(d)) of that state, and no amount shall be includible in gross income by reason of the transfer, if the conditions in paragraph (b)(4)(ii) of this section are met. A transfer under this paragraph (b)(4) is not treated as a distribution for purposes of Sec. 1.457-6. Therefore, such a transfer may be made before severance from employment.

(ii) Conditions for plan-to-plan transfers from an eligible governmental plan to a qualified plan. A transfer may be made under this paragraph (b)(4) only if the transfer is either--

(A) For the purchase of permissive past service credit (as defined in section 415(n)(3)(A)) under the receiving defined benefit governmental plan; or

(B) A repayment to which section 415 does not apply by reason of section 415(k)(3).

(iii) Example. The provisions of this paragraph (b)(4) are illustrated by the following example:

Example. (i) Facts. Plan X is an eligible governmental plan maintained by County Y for its employees. Plan X provides for distributions only in the event of death, an unforeseeable emergency, or severance from employment with Y (including retirement from Y). Plan S is a qualified defined benefit plan maintained by State T for its employees. County Y is within State T. Employee A is an employee of Y and is a participant in Plan X. Employee A previously was an employee of T and is still entitled to benefits under Plan S. Plan S includes provisions allowing participants in certain plans, including Plan X, to transfer assets to Plan S for the purchase past service credit under Plan S not in excess of the credit permitted under section 415(n) and does not permit the amount transferred to exceed the amount necessary to fund the benefit resulting from the past service credit. Although not required to do so, Plan X allows A to transfer assets to Plan T to provide a past service benefit under Plan T.

(ii) Conclusion. Assuming that the special rules at section 415(n)(3) are satisfied with respect to the transfer, the transfer is permitted under this paragraph (b)(4).

(c) Qualified domestic relations orders under eligible plans--(1) General rule. An eligible plan does not become an ineligible plan described in section 457(f) solely because its administrator or sponsor complies with a qualified domestic relations order as defined in section 414(p), including an order requiring the distribution of the benefits of a participant to an alternate payee in advance of the general rules for eligible plan distributions under Sec. 1.457-6. If a distribution or payment is made from an eligible plan to an alternate payee pursuant to a qualified domestic relations order, rules similar to the rules of section 402(e)(1)(A) shall apply to the distribution or payment.

(2) Examples. The provisions of this paragraph (c) are illustrated by the following examples:

Example 1. (i) Facts. Participant C and C's spouse D are divorcing. C is employed by State S and is a participant in an eligible plan maintained by S. C has an account valued at \$100,000 under the plan. Pursuant to the divorce, a court issues a qualified domestic relations order on September 1, 2003 that allocates 50 percent of C's \$100,000 plan account to D and specifically provides for an immediate distribution to D of D's share within 6 months of the order. Payment is made to D in January of 2004.

(ii) Conclusion. S's eligible plan does not become an ineligible plan described in section 457(f) and Sec. 1.457-11 solely because its administrator or sponsor complies with the qualified domestic relations order requiring the immediate distribution to D in advance of the general rules for eligible plan distributions under Sec. 1.457-6. In accordance with section 402(e)(1)(A), D (not C) must include the distribution in gross income. The distribution is includible in D's gross income in 2004. If the qualified domestic relations order were to provide for distribution to D at a future date, amounts deferred attributable to D's share will be includible in D's gross income when paid to D.

Example 2. (i) Facts. The facts are the same as in Example 1, except that S is a tax-exempt entity, instead of a state.

(ii) Conclusion. S's eligible plan does not become an ineligible plan described in section 457(f) and Sec. 1.457-11 solely because its administrator or sponsor complies with the qualified domestic relations order requiring the immediate distribution to D in advance of the general rules for eligible plan distributions under Sec. 1.457-6. In accordance with section 402(e)(1)(A), D (not C) must include the distribution in gross income. The distribution is includible in D's gross income in 2004, assuming that the plan did

not make the distribution available to D in 2003. If the qualified domestic relations order were to provide for distribution to D at a future date, amounts deferred attributable to D's share would be includible in D's gross income when paid or made available to D.

(d) Death benefits and life insurance proceeds. A death benefit plan under section 457(e)(11) is not an eligible plan. In addition, no amount paid or made available under an eligible plan as death benefits or life insurance proceeds is excludable from gross income under section 101.

(e) Rollovers to eligible governmental plans--(1) General rule. An eligible governmental plan may accept contributions that are eligible rollover distributions (as defined in section 402(c)(4)) made from another eligible retirement plan (as defined in section 402(c)(8)(B)) if the conditions in paragraph (e)(2) of this section are met. Amounts contributed to an eligible governmental plan as eligible rollover distributions are not taken into account for purposes of the annual limit on annual deferrals by a participant in Sec. 1.457-4(c) or Sec. 1.457-5, but are otherwise treated in the same manner as amounts deferred under section 457 for purposes of Secs. 1.457-3 through 1.457-9 and this section.

(2) Conditions for rollovers to an eligible governmental plan. An eligible governmental plan that permits eligible rollover distributions made from another eligible retirement plan to be paid into the eligible governmental plan is required under this paragraph (e)(2) to provide that it will separately account for any eligible rollover distributions it receives.

(3) Example. The provisions of this paragraph (e) are illustrated by the following example:

Example. (i) Facts. Plan T is an eligible governmental plan that provides that employees who are eligible to participate in Plan T may make rollover contributions to Plan T from amounts distributed to an employee from an eligible retirement plan. An eligible retirement plan is defined in Plan T as another eligible governmental plan, a qualified section 401(a) or 403(a) plan, or a section 403(b) contract, or an individual retirement arrangement (IRA) that holds such amounts. Plan T requires rollover contributions to be paid by the eligible retirement plan directly to Plan T (a direct rollover) or to be paid by the participant within 60 days after the date on which the participant received the amount from the other eligible retirement plan. Plan T does not take rollover contributions into account for purposes of the plan's limits on amounts deferred that conform to Sec. 1.457-4(c). Rollover contributions paid to Plan T are invested in the trust in the same manner as amounts deferred under Plan T and rollover contributions

(and earnings thereon) are available for distribution to the participant at the same time and in the same manner as amounts deferred under Plan T. In addition, Plan T provides that, for each participant who makes a rollover contribution to Plan T, the Plan T recordkeeper is to establish a separate account for the participant's rollover contributions. The recordkeeper calculates earnings and losses for investments held in the rollover account separately from earnings and losses on other amounts held under the plan and calculates disbursements from and payments made to the rollover account separately from disbursements from and payments made to other amounts held under the plan.

(ii) Conclusion. Plan T does not lose its status as an eligible governmental plan as a result of the receipt of rollover contributions.

(f) Deemed IRAs under eligible governmental plans. [Reserved]

Sec. 1.457-11 Tax treatment of participants if plan is not an eligible plan.

(a) In general. Under section 457(f), if an eligible employer provides for a deferral of compensation under any agreement or arrangement that is an ineligible plan--

(1) Compensation deferred under the agreement or arrangement is includible in the gross income of the participant or beneficiary for the first taxable year in which there is no substantial risk of forfeiture (within the meaning of section 457(f)(3)(B)) of the rights to such compensation;

(2) If the compensation deferred is subject to a substantial risk of forfeiture, the amount includible in gross income for the first taxable year in which there is no substantial risk of forfeiture includes earnings thereon to the date on which there is no substantial risk of forfeiture;

(3) Earnings credited on the compensation deferred under the agreement or arrangement that are not includible in gross income under paragraph (a)(2) of this section are includible in the gross income of the participant or beneficiary only when paid or made available to the participant or beneficiary, provided that the interest of the participant or beneficiary in any assets (including amounts deferred under the plan) of the entity sponsoring the agreement or arrangement is not senior to the entity's general creditors; and

(4) Amounts paid or made available to a participant or beneficiary under the agreement or arrangement are includible in the gross income of the participant or beneficiary under section 72, relating to annuities.

(b) Exceptions. Paragraph (a) of this section does not apply with respect to--

- (1) A plan described in section 401(a) which includes a trust exempt from tax under section 501(a);
- (2) An annuity plan or contract described in section 403;
- (3) That portion of any plan which consists of a transfer of property described in section 83;
- (4) That portion of any plan which consists of a trust to which section 402(b) applies; or
- (5) A qualified governmental excess benefit arrangement described in section 415(m).

(c) Coordination of section 457(f) with section 83--(1) Transfer of property described in section 83. Under paragraph (b)(3) of this section, section 457(f) and paragraph (a) of this section do not apply to that portion of any plan which consists of a transfer of property described in section 83. For this purpose, a transfer of property described in section 83 means a transfer of property to which section 83 applies. Section 457(f) and paragraph (a) of this section do not apply if the date on which there is no substantial risk of forfeiture with respect to compensation deferred under an agreement or arrangement that is not an eligible plan is on or after the date on which there is a transfer of property to which section 83 applies. However, section 457(f) and paragraph (a) of this section apply if the date on which there is no substantial risk of forfeiture with respect to compensation deferred under an agreement or arrangement that is not an eligible plan precedes the date on which there is a transfer of property to which section 83 applies. If deferred compensation payable in property is includible in gross income under section 457(f), then, as provided in section 72, the amount includible in gross income when that property is later transferred or made available to the service provider is the excess of the value of the property at that time over the amount previously included in gross income under section 457(f).

(2) Examples. The provisions of this paragraph (c) are illustrated in the following examples:

Example 1. (i) Facts. As part of an arrangement for the deferral of compensation, an eligible employer agrees on December 1, 2002 to pay an individual rendering services for the eligible employer a specified dollar amount on January 15, 2005. The arrangement provides for the payment to be made in the form of property having a fair market value equal to the specified dollar amount. The individual's rights to the payment are not subject to a substantial risk of forfeiture (within the meaning of section 457(f)(3)(B)).

(ii) Conclusion. In this example, because there is no substantial risk of forfeiture with respect to the agreement to

transfer property in 2005, the present value (as of December 1, 2002) of the payment is includible in the individual's gross income for 2002. Under paragraph (a)(4) of this section, when the payment is made on January 15, 2005, the amount includible in the individual's gross income is equal to the excess of the fair market value of the property when paid, over the amount that was includible in gross income for 2002 (which is the basis allocable to that payment).

Example 2. (i) Facts. As part of an arrangement for the deferral of compensation, individuals A and B rendering services for a tax-exempt entity each receive in 2010 property that is subject to a substantial risk of forfeiture (within the meaning of section 457(f)(3)(B) and within the meaning of section 83(c)(1)). Individual A makes an election to include the fair market value of the property in gross income under section 83(b) and individual B does not make this election. The substantial risk of forfeiture for the property transferred to individual A lapses in 2012 and the substantial risk of forfeiture for the property transferred to individual B also lapses in 2012. Thus, the property transferred to individual A is included in A's gross income for 2010 when A makes a section 83(b) election and the property transferred to individual B is included in B's gross income for 2012 when the substantial risk of forfeiture for the property lapses.

(ii) Conclusion. In this example 2, in each case, the compensation deferred is not subject to section 457(f) or this section because section 83 applies to the transfer of property on or before the date on which there is no substantial risk of forfeiture with respect to compensation deferred under the arrangement.

Example 3. (i) Facts. In 2010, X, a tax-exempt entity, agrees to pay deferred compensation to employee C. The amount payable is \$100,000 to be paid 10 years later in 2020. The commitment to make the \$100,000 payment is not subject to a substantial risk of forfeiture. In 2010, the present value of the \$100,000 is \$50,000. In 2018, X transfers to C property having a fair market value (for purposes of section 83) equal to \$70,000. The transfer is in partial settlement of the commitment made in 2010 and, at the time of the transfer in 2018, the present value of the commitment is \$80,000. In 2020, X pays C the \$12,500 that remains due.

(ii) Conclusion. In this example 3, C has income of \$50,000 in 2010. In 2018, C has income of \$30,000, which is the amount transferred in 2018, minus the allocable portion of the basis that results from the \$50,000 of income in 2010. (Under section 72(e)(2)(B), income is allocated first. The income is equal to \$30,000 (\$80,000 minus the \$50,000 basis), with the result that the allocable portion of the basis is equal to \$40,000 (\$70,000 minus the \$30,000 of income).) In 2020, C has income of \$2,500 (\$12,500

minus \$10,000, which is the excess of the original \$50,000 basis over the \$40,000 basis allocated to the transfer made in 2018).

Sec. 1.457-12 Effective dates.

Sections 1.457-1 through 1.457-11 apply for taxable years beginning after December 31, 2001, except that Sec. 1.457-11(c) does not apply with respect to an option without a readily ascertainable fair market value (within the meaning of section 83(e)(3)) that was granted on or before May 8, 2002 and, except that Sec. 1.457-10(c) (relating to qualified domestic relations orders) applies for transfers, distributions, and payments made after December 31, 2001.